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No. 426

IN THE

Supreme Court of the United States

OCTOBER TERM 1948

WORLD PUBLISHING COMPANY, A CORPORATION, PETITIONER,

vs.

UNITED STATES OF AMERICA, RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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PEERLESS PRINTING COMPANY, DENVER

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

World Publishing Company prays for a writ of certiorari to review the judgment of the United States Circuit Court of Appeals for the Tenth Circuit entered July 15, A. D. 1948 (R. 296), rehearing denied August 26, A. D. 1948 (R. 303).

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 283) is reported in 169 Fed. (2d) 186, and of the U. S. District Court (R. 43) in 72 Fed. Supp. 886.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 15, 1948, and petition for rehearing which had been duly filed was denied on August 26, 1948 (R. 303).

The jurisdiction of this Court is invoked under Sec-

tion 1254 and Section 2101(c), *Title 28, United States Code, Judiciary and Judicial Procedure,* effective September 1, 1948.

QUESTIONS PRESENTED

1. Whether within the meaning of Section 102 of the Internal Revenue Code an accumulation of reserve by petitioner newspaper for the purchase of needed printing presses and building to house the same was unreasonable because immediate purchase in the years in question—1942 and 1943—was prevented by the war.

2. Whether refusal by the court to permit under Section 102 any accumulation of surplus by a newspaper for the purpose of meeting the exigencies and uncertainties of war, was arbitrary and unreasonable.

3. Whether the newspaper business was of a type so "slightly affected" by the war that it was unreasonable in 1942 and 1943 to anticipate any future uncertainty and to accumulate any reserve to meet it.

4. Whether the accumulation of reserve by a newspaper for the purpose of entering the radio broadcasting business is *per se* outside and beyond the reasonable needs of the newspaper business.

5. Whether a determination of business need such as fair-minded directors might make in good faith, may be held unreasonable and indicative of improper motive under Section 102, merely because a different conclusion would have been reached by the majority of the court had it been sitting as the board.

6. Whether the earnings and profits of petitioner newspaper were permitted to accumulate beyond the reasonable needs of its business in the years 1942 and 1943.

7. Whether petitioner newspaper was availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting earnings or profits to accumulate instead of being divided or distributed within the meaning of Sec. 102 of the Internal Revenue Code.

8. Whether there was substantial evidence to support the findings of the court.

STATUTE INVOLVED

The statute and pertinent sections of the regulations involved are set out in the Appendix (*infra*. pp. 1-3).

STATEMENT

The Commissioner of Internal Revenue assessed against petitioner penalty taxes under Sec. 102 of the Internal Revenue Code for the improper accumulation of surplus in excess of the reasonable needs of the business during the years 1942 and 1943.

Taxpayer paid the tax in the amount of $22,118.41 for the year 1942, and $19,524.30 for the year 1943, duly filed its claim for refund (R. 51) and on failure of the Commissioner to act within the period of six months thereafter, sued the United States in the District Court.*

The District Court sustained the tax on the ground that the accumulations for both 1942 and 1943 were in excess of the reasonable needs of the business in those years. The Circuit Court of Appeals, Judge Phillips dissenting, sustained the District Court.

Petitioner is the owner and publisher of the Tulsa World, a morning newspaper with a circulation of over 70,000 daily and 110,000 Sunday (R. 48). The Company's stock is owned by Eugene Lorton (R. 61), 77 years old at the date of the trial in 1947 (R. 81).

The accumulated surplus December 31, 1941, was $562,521.98 (R. 53). The net quick assets, however, available for its expansion program, meeting the contingencies and shortages of war and entering the radio broadcasting business were only $496,168.65 (R. 35), the balance of the surplus having been used in purchasing permanent plant equipment, lot for the new building, etc. (Ex. A, R. 139; Ex. F, R. 35). (Exhibits A-G stipulated R. 18-21).

*Suit was against the United States instead of the Collector because the Collector to whom the tax was payable had resigned at the time the suit was brought.

Its net earnings after Federal taxes were $80,430.59 in 1942 and $70,997.44 in 1943. These were the amounts held by the court to have been accumulated beyond the reasonable needs of the business in those years (R. 51).

The three reasons for the accumulation given by the World were:

(1) The necessary replacement of obsolete and worn out printing presses and equipment together with a new building to house the new machinery, all as a part of a general improvement and expansion program.

(2) The need for a reserve to meet the exigencies and uncertainties of the war.

(3) The need for a reserve for the purpose of entering the radio broadcasting business.

The president and the editor both testified that the sole purpose of the accumulation was to meet the business needs of the corporation, not to avoid the surtax (R. 63, 64, 82). There was no testimony disputing this. There were no loans to the president nor to any stockholder nor others (R. 45). The investments were of a type quickly convertible to needed cash (R. 29). There was no claim by the government that any of the capital (excluding net quick assets being accumulated for the purposes stated above) was used for any purpose other than the reasonable needs of the business. Eugene Lorton would have paid a greater tax of $69,520.35 had the earnings been distributed (R. 45).

The evidence was undisputed that the World's printing presses dated from 1914 or 1915 (R. 100) were purchased second hand (R. 64), operated at about one-third the speed of modern presses (R. 93), did an inadequate job (R. 94) and that without faster and better production the World couldn't stay in business in ordinary times (R. 98), that a new building was necessary to house the equipment (R. 64-65), that in addition to the building and presses many of the linotypes were obsolete and it was necessary to install many more at a cost of $5,000 to $7,500 each (R. 94).

It was undisputed that these matters were discussed at directors' meetings for several years prior to 1942 (R. 49), and that in 1940 a lot for the building was purchased for $60,000 (R. 79) and announcement of the plans made in the newspaper (R. 85), but that the program was prevented from immediate fulfillment by the war (R. 79, 85, 92). A contract for the purchase of the presses and erection of the building was entered into in January, 1945 (R. 89), and the printing presses were expected to be delivered by June 1, 1947 (R. 93). The building was being constructed at the time of the trial (R. 79).

The need for the presses, the building and the improvement program was not disputed by the government. The intent to proceed therewith as soon as the war permitted was unchallenged.

In 1942 the estimated *minimum* cost of the building and presses and other equipment (exclusive of the linotypes) was $500,000 (R. 40). Under a joint printing arrangement the Tribune, a Tulsa evening paper, had agreed to assume half of the cost of the presses only (R. 90), but it was doubtful whether it could meet its commitment (R. 110) and the Circuit Court held it was "perhaps necessary for the World to be prepared to advance the full cost of the presses and auxiliary equipment." The contract for purchase was made by the World alone (R. 90, 55).

The purchase contract for the equipment (exclusive of the linotypes) had a base price in 1945 (subject to an escalator clause) of $636,489.38, and a building cost base estimate of $301,000—making a total base cost as of that date of $938,089.38 (R. 80, 81) subject to escalation as prices rose. With the addition of the necessary linotypes at a minimum cost of $5,000 each, the total base or minimum cost amounted to approximately a million dollars. The escalation clause has of course greatly increased this cost as the inflation has progressed (R. 23).

The fear of war exigencies, the need for accumulation to meet its uncertainties and the danger of weakening the company's cash position were voiced in the minutes of the

directors' meeting of December 21, 1942 (R. 49, 50). Severe handicaps of the war and curtailment of advertising because of newsprint shortage (R. 83) was undisputed.

The District Court held that newspapers had no reason for anxiety, that "it was a type of business which the war affected comparatively slightly in its day-to-day operations • • • it encountered some shortages such as gasoline, tires, automotive equipment and newsprint, but they did not put the newspaper business in a financially precarious position or indicate any financial uncertainty for the future." There was no evidence to support this finding (R. 53-54).

The Circuit Court likewise held: "During this time the financial status of the Tulsa Tribune might well be expected to improve and the prosperous condition of taxpayer to continue; and further earnings could no doubt be expected" (169 Fed. (2d) 186, 189; Record 287).

The World had for a number of years attempted to get into the radio broadcasting business, had filed an application in 1936 which was approved by the F.C.C. examiner but rejected in a later year by the Commission; had continued negotiations to purchase a station thereafter and had in 1944 and 1945 filed with the Federal Communications Commission, an application for a frequency modulation station (R. 94, 95).

The District Court held that "the proposed venture into the radio broadcasting business was not a part of the needs of this business" (R. 55). There was no evidence to support the finding.

Both of the lower courts based their decision solely on the reasonable needs of the business. Both admitted the corporation was not formed for the purpose of avoiding the surtax (R. 44).

The Opinions below are not entirely clear but appear to rest on the following grounds:

1. While the reasonable needs of the business required

the new equipment and new building, accumulation for that purpose was unreasonable while war priorities prevented purchase.

2. Since the base or *minimum estimated cost* of the plant improvements in 1942 was $500,000 there was sufficient reserve to meet it and it was unreasonable for the directors to anticipate the rise in base cost to $938,000 by 1945, or a further rise under the escalator clause since that time.

3. That in any event the company was prosperous and in 1942 should have anticipated that the war would bring no serious difficulty to the newspaper business and that earnings would continue good, in which case it could accumulate reserves in later years.

4. That accumulation for war exigencies was not justifiable in the newspaper business. Nor was radio broadcasting a reasonable need of the business.

5. That the proper measure of the reasonableness of the accumulation was total surplus rather than quick assets.

SPECIFICATIONS OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding there was evidence to support the findings of the District Court.

2. In holding that within the meaning of Section 102 of the Internal Revenue Code an accumulation of reserve by the World for the purchase of admittedly needed improvements was unreasonable because immediate purchase in the years in question (1942 and 1943) was prevented by the war.

3. In refusing to hold that the exigencies and uncertainties of war were reasonable grounds under Section 102 for the accumulation of surplus by taxpayer.

4. In failing to hold that accumulation of surplus by taxpayer for the purpose of entering the radio broadcast-

ing business was a reasonable ground for accumulation within the meaning of Section 102.

5. In holding that improper motive may be inferred from an accumulation for business needs which in all the circumstances might be made by fair-minded directors acting in good faith.

6. In holding that the accumulation of surplus by taxpayer was beyond the reasonable needs of its business within the meaning of Section 102 and that taxpayer was therefore availed of for the purpose of preventing the imposition of the surtax.

7. In holding taxpayer liable for the penalty tax under Section 102 of the Internal Revenue Code.

REASON FOR GRANTING THE WRIT

The decision below decided important questions of federal law which have not been, but should be, settled by this Court.

This case is probably the most extreme that has yet been decided under Section 102 of the Internal Revenue Code. It is contrary to the repeated reassurances made by the Department to the public. It is a matter of grave concern to all industry that it have some means of knowing whether it can expand and grow. The case was decided solely on the question of the reasonable needs of the business and the decision applies alike to companies with many stockholders and to those that are wholly owned.

Its importance to the newspapers of the country can hardly be overestimated because it singles that industry out—declares that at its peril it should have foreseen in 1942 what the court believes it can see in 1947—that the war would but slightly affect the business and that newspaper profits would continue to rise. Under this ruling few newspapers are not subject to attack.

It decides—certainly for the purposes of the Bureau of Internal Revenue—that the radio broadcasting business is not a proper newspaper function for which accumulation

of surplus can be made without penalty.* Approximately one-third of the radio stations of the country are owned wholly or in part by newspapers, and others are constantly applying for permits.** Many of these will be subject to attack under Section 102 if this decision stands.

The theory of Section 102 has heretofore been that the maintenance of a business in a reasonably efficient state of operation and even its growth and expansion—particularly if the business is a small concern such as this—were desirable and were not intended to be hampered or penalized by the law.

The distinction is made by the court that while the building and equipment were reasonable needs of the business, yet accumulation of surplus for the purpose of satisfying those needs as soon as the equipment was available, was unreasonable. Such a distinction would deny to many small businesses any right to substantial growth. Most businesses are not in a position to accumulate in a year or two sufficient surplus for substantial plant replacement, expansion or improvement.

Few of the great newspapers could have emerged under such a rule—Och's New York Times, Pulitzer's New York World, Myers and McLean's Washington Post, Joseph B. Tate's Washington Star, Bonfils' Denver Post, Patterson's Rocky Mountain News, Nelson's Kansas City Star, McCormick's Chicago Tribune and William Allen White's Emporia Gazettes,—all rose from small beginnings; the accumulation of their reserves was the keystone of their rise to greatness.

II.

The decision below is in conflict with the decision of other Circuit Courts of Appeals on the questions involved and in conflict with applicable decisions of the Tax Court.

*Record, P. 55, par. 33: "The proposed venture into the radio broadcasting business was not a part of the needs of this business. The same finding as to remoteness would also strike such a venture down as a purpose for the accumulation by the World in 1942 and 1943."

**Journalism in the United States by Robert W. Jones, p. 578.

The important question to industry—what are the reasonable needs of a business within the meaning of Section 102 of the Internal Revenue Code—has received widely variant answers by the different Circuit Courts.

The leading case in the Ninth Circuit and one many times cited with approval by the Tax Court is *Commissioner of Internal Revenue v. Cecil B. de Mille Productions, Inc.*, 90 Fed. (2d) 12 (CCA 9) affirming 31 B.T.A. 1161. The need for accumulating $4 million dollars over a period of years in order to enable taxpayer to produce pictures for itself instead of producing for others at their expense, was held by the Tax Court to be an accumulation for the reasonable needs of the business, and not subject to the penalty tax for the six years claimed by the Commissioner. This was affirmed by the Circuit Court of Appeals.

In the Ninth Circuit that is still good law. In the Tenth it is not.

The de Mille case has been approved by the Tax Court many times. The recent case of *Lion Clothing Company v. Commissioner*, 8 Tax Court, 1181 (1947) specifically approves as reasonable an accumulation over a period of years of profits to be added to surplus for "improvements which will add to the convenience and efficiency of operation of the business" and the accumulation of cash reserves "to meet unknown risks of war and post-war period."

This case was acquiesced by the Bureau of Internal Revenue 1947-2 CB 3 and will probably be the rule followed by it in determining what corporations to attack under Section 102 in some circuits, but not in the Tenth where the Bureau will be bound by the contrary rule of the World Publishing Company case.

In *Dill Manufacturing Company v. Commissioner*, 39 B.T.A. 1023 the de Mille case is cited with approval to the proposition that "the law does not require that 'a business should remain static: it must be assumed that any business shall have the right to grow' * * *," and the legal test is given whether the corporation "permitted its course

of conduct to be diverted from its normal business interest by a purpose to save its stockholders from surtax".

To the same effect, *Kennedy Name Plate Co. v. Com.*, Tax Court Docket No. 6695, CCH Tax Ct. Memo Dec. 15841 M (May 29, 1947).

In the other circuits the law remains so uncertain that no lawyer can intelligently advise his clients, no board of directors can know when it will incur the penalty, nor can the Commissioner of Internal Revenue instruct his revenue agents so as to avoid the discriminatory, uncertain and haphazard methods of enforcement now necessary.

CONCLUSION

Inherent in the court's decision is a misconstruction of the law—important to all business corporations in the United States. It stems from the failure of the majority of the court to clearly perceive the purpose of the "reasonable needs of the business" provision of the statute. The purpose was to determine whether the directors were acting in good faith. It was not to substitute the court for the board of directors. The circumstance that the judges, looking back, think they would have decided the business question differently is not enough to indicate improper motives. Reasonable needs are such as intelligent, fair-minded men in good faith might deem proper in the light of the then existing situation. They do not become unreasonable within the meaning of the law because four years later when the anxieties and uncertainties of war have disappeared the court thinks it would have decided the business questions differently. That the court failed to apply the correct test is self-evident in the light of the dissenting opinion of Judge Phillips, who clearly indicates that had he been sitting on the board of directors his determination of the business needs involved would have been that of the World's directors and not that of his colleagues on the court.

The desision below determines questions of federal law of general importance which have not been, but should be, settled by this court. It conflicts with decisions of other Circuits and decisions of the Tax Court. It is, therefore, respectfully submitted that the petition for certiorari should be granted.

Respectfully submitted,

WORLD PUBLISHING COMPANY,

By MORRISON SHAFROTH and
BYRON V. BOONE,

Attorneys for Petitioner.

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WORLD PUBLISHING COMPANY, A CORPORATION, PETITIONER,

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UNITED STATES OF AMERICA, RESPONDENT.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

STATEMENT OF THE CASE

A statement of the case, specification of errors to be urged and jurisdiction are contained in the Petition for Certiorari (pp. 3, 3 and 1).

ARGUMENT

IMPORTANCE TO NEWSPAPERS OF RIGHT TO ACCUMULATE EARNINGS FOR UNCERTAINTIES OF FUTURE

This case is not one in which there is any independent finding of an intent to avoid the surtax. The tax here is imposed solely because of the court's determination as to the reasonable needs of the business. It is not one in which the company is found to have been used as an incorporated pocket-book, or in which loans have been made to stockholders, or in which an owner has carried his investments in the company for his own uses.

The newspaper business is historically largely a single ownership business which has from the very beginning pulled itself up by its bootstraps. It is, moreover, notoriously a feast or famine business, subject to the vicissitudes of public opinion, dependent on the genius and ability of the publisher, and capable of losing enormous amounts of money in a short time. The Washington Post grew from its little beginning under Hutchins to greatness and wealth under John R. McLean and collapsed into virtual bankruptcy after his death under the inept management of his son. It has risen again under the ownership of Eugene Meyer. The Washington Star grew to greatness from the $500 investment of Joseph B. Tate. The tragic demise of the 111 year old Boston Transcript—unable to meet the changing tides of public opinion and failing utterly in 1941 for lack of a few hundred thousand dollars of reserve; the bitter fate of "P.M." with its 125,000 circulation and its millions of dollars of losses; the failure in 1942 of the Kansas City Journal and the Philadelphia Ledger; all are object lessons refuting the principle that a newspaper is just like an investment company, and needs no reserves.

The failure of the court to realize this distinction and its inability to retreat from the security and omniscience of 1947 to the anxiety and uncertainties that faced the World's board of directors and the whole nation in 1942 and 1943, are basic defects in the court's approach to this case. Looking back the court can see that we were sure to win the war, that the directors should not have been disturbed about it, that there would be no important labor shortages, no loss of any source of revenue to newspapers, no serious fluctuation in price of newsprint, ink, machinery or labor*; that nothing adverse to the prosperity of the business was in prospect and that all the war shortages would "not put the newspaper business in a financially precarious position or indicate any financial uncertainty for the future".** (R.54)

"It was a type of business," says the court, "which the

* *See note on following page.

war affected comparatively slightly in its day-to-day operation." (R. 53)

When the Board of Directors met, however, on December 21, 1942, and expressed anxiety as to the future, our fleet had been sunk at Pearl Harbor, our men were pouring into the army by the millions; Hitler was trampling over the peoples of Europe, shortages of almost everything

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*Newsprint, Industry Report, Pulp and Paper, Sept. 1948, page 14, U. S. Department of Commerce. Index of Wholesale prices 1926=100.

Annual Averages	
1939	69.6
1940	69.6
1941	69.6
1942	69.6
1943	76.2
1944	80.8
1945	83.9
1946	100.7
1947	123.4
1948 (June)	133.7 (Aug. '48 issue, p. 38)

Average Hourly Earnings
Newspaper and Periodical Industry
Monthly Labor Review, Oct., 1948, Page 452

1939—100.4 cents
1941—105.2 cents
1947—171.3 cents
July, 1948—189.4 cents

**See finding 26, p. 53,

"* * * This company was strong, both currently and historically. It had no debts except current operating ones. It had virtually no competition. The size and wealth of its circulation territory has been constantly growing. As a result of its printing arrangement with the Tribune its 1942 net earnings almost trebled its previous 8-year average—even after deducting high war-time taxes—and more than trebled it in 1943. It faced no substantial change in the art, no sudden loss of any substantial part of its source of revenue. The basis of its revenue was broad and stable. *None of the operating materials it had to buy nor the product and service it had to sell were subject to serious fluctuations in price.* Its business depends on the life of no patents. It was concerned with no erratic investment values. *The possibility of labor unrest was not a serious problem.* Legislation adverse to the prosperity of the business was not in prospect. *It was a type of business which the war affected comparatively slightly in its day-to-day operations.* It had none of the problems of conversion into wartime production and post-war re-conversion. Restriction of foreign commerce could affect it little. *It encountered some shortages, such as gasoline, tires, automotive equipment and newsprint, but they did not put the newspaper business in a financially precarious position, or indicate any financial uncertainty for the future.*" (Italics ours.)

Judge Phillips in his dissent says:

"* * * The World could not determine, with certainty, that it would be able to make large earnings in 1945 and 1946. Newsprint was scarce. It was rationed severely. Advertising space had to be greatly curtailed. There was a short period when the World was unable to print any advertising whatever. It seems to me it was altogether reasonable for the World to set aside funds on hand to meet its imperative expansion program and it was not required to run the hazard of obtaining that necessary reserve from uncertain future earnings" (R. 295).

from gasoline to newsprint were in sight, a 90% excess profit tax had been enacted, and the public forecasts* for the newspaper business were lacking in the optimism which the court holds should have guided the World's board of directors and induced it to distribute as dividends all of its reserves above the *minimum* (and admittedly grossly inadequate) estimated cost of the necessary machinery and building.

Mr. Justice Douglas delivered an address to the newspaper men of the Northwest on June 20, 1942, in which he said *(Life, July 13, 1942.* p. 11):

"The realities of American life in 1942 revolve around the fact that we have an army of 4 million men.

*In *Commonweal*, May 29, 1942, page 132, an article dealing with newspapers says: "Almost every day somewhere in the country one or more publications, from large and sometimes long established daily newspapers, to small specialized magazines and bulletins pass from the scene, victims of the conditions produced by the war. In all probability, as all publishers and editors and the many other classes affiliated with their work such as printers and paper makers and news dealers, are anxiously aware, hundreds and perhaps thousands of publications must perish. The number will vary according to the length of the war.

"It may well be, however, that quite irrespective of the time that may be needed for the waging of the war—whether much or little—our press in any case is destined for drastic and possibly quite fundamental changes and reorganization. * * * Future prospects for advertising revenue in anything like the prodigious amount characteristic of our journalism until only yesterday seem very dubious, to say the least."

Business Week, May 2, 1942, page 48, "*Newspaper Pinch*":

"Making no bones about the fact that they are in a tight spot, the members of the American Newspaper Publishers Association sat down in Manhattan last fortnight to their 56th annual convention. March lineage as measured by Media Records, Inc., in 52 cities was almost scraping depression lows, dropping 6½% under the same month in 1941. Automotive Review—once the reliable standby in the field of national advertising—was in a dead swoon. Lineage was off 67% from 1941."

News Week, March 2, 1942, page 52, "*Newspapers Trim Their Sails to Weather Shortage Blow*":

"Today United States newspapers are only beginning to tighten their belts as they feel the ever increasing pinch of priorities and war production."

News Week, January 11, 1943, "*Wartime Shrinkage of United States Press Begins with War Production Board's First 10% Cut*":

"Despite the cuts, the War Production Board says it will be possible to start a newspaper. But first, Chandler recommends that the would-be publisher see an alienist."

Probably it will soon be increased by as many as another 4 million men. No inside information or specialized knowledge is needed to understand what this means. There is not a home in America where this is not spontaneously understood. Our people know that this war is being fought for the next 1,000 years of history.

* * * * *

"Everyone understands why we are building this army and navy. Our finest men are pouring into it, to serve for the duration. And yet, a highly patriotic and victory-minded fraction of our press has hardly yet faced the fact that we are in mortal danger. Our boys in uniform believe it—that's why they are there! Their families believe it—they know their boys must fight and they are proud to have them go. And the majority of the press feels the same way. But some well intentioned publications are in the main describing an unreal war, in which it would appear that we have little left to do except prepare to receive the imminent surrender of the enemy. * * *

"We are fighting a people's war and therefore we need a friendly, a vigilant and a well informed press to help lead us."

We submit that the court's requirement that business directors act with the assurance of a "second guesser" at the commencement of a great war, is arbitrary and unfair to all industry.

THE COURT APPLIED AN IMPROPER STANDARD. "BUSINESS NEED," NOT "IMMEDIATE EXPENDITURE," IS THE LAWFUL TEST

The proceeding against the World Publishing Company had its inception in the report of the agent for the Internal Revenue Bureau dated March 24, 1945, (P. Ex. 1, R. 118, 128, 129, admitted R. 60). He gives his reason for asserting a deficiency as follows:

"The need for new presses appears to be real and it is the Examiner's opinion that they will be installed as soon as practicable after the termination of the war. The Examiner is not familiar with the costs of such equipment, and he is unprepared to state whether the costs as estimated by Mr. Lorton represent reasonable peace time costs or whether they contain an element of increased costs due to war-time influences.

"But as of Dec. 31, 1942, there was no reason to anticipate an early cessation of hostilities and the consequent loosening of war time priorities. The corporation's management therefore at the close of the year 1942 would have no reasonable hope that the desired new equipment could be purchased in the immediate future. The accumulated cash and 'unrelated' assets exceeded the total *minimum* anticipated costs of the new equipment and new building as estimated at that time. * * *

"It is, therefore, concluded that an accumulation beyond the reasonable needs of the business existed at December 31, 1942, and application of Section 102 is recommended."*

The District Court affirmed the Revenue Agent's finding, saying:

"As the World could not have used the accumulations for its planned expansions during 1942, 1943, or a reasonable time thereafter, and as there was adequate surplus previously accumulated to meet all reasonable demands, the plaintiff has failed to overcome by a preponderance of the evidence the finding of the Commissioner and the tax must stand." (R-57)

*The National Industrial Conference Board in its report "Effects of Taxes upon Corporate Policy" (1943), p. 49, points out that the Revenue Agent is the instrumentality by which the Bureau acts and says, "But the Bureau of Internal Revenue is a tax collecting agency, not a business management advisory board, and is therefore not presumed to be qualified to tell corporation executives how the finances of their business should be handled. The effect of Section 102, however, is to give to that Bureau the authority to make vital decisions without corresponding responsibility for the consequences of such decisions."

Said the Circuit Court of Appeals:

"It is agreed that at the time these reserves were set up the contemplated improvements could not be made on account of the war. No one knew when they would be made. It was reasonable to assume that a number of years would ensue. During this time the financial status of the Tulsa Tribune might well be expected to improve and the properous condition of the taxpayer to continue and further earnings could no doubt be expected." (R-287)

"* * * There was nothing in the picture to indicate that these profits would not continue or even increase." (R-289)

Said Judge Phillips in his dissent:

"Surely a business enterprise with obsolete and badly worn equipment might during the War Period legitimately set aside a reserve fund to replace that equipment when available and to construct the building necessary to house such equipment. To do so would be ordinary business prudence." (R-294)

THE INADEQUACY OF THE RESERVES TO MEET THE NECESSARY IMPROVEMENTS IS UNDISPUTED

The inadequacy of all of the accumulations including those of 1942 and 1943, to pay for the needed presses and building when actually constructed, is undisputed—allowing nothing whatever for the uncertainties of a war. But the court conceded nothing over the *minimum* estimated cost in 1942. Its standard is the $500,000 which the district court itself recognized was far below the cost. (Finding 20 R. 51). The reason for refusing to allow the actual contract base cost as shown at the trial appears to rest on the theory that it would have been unreasonable for the Directors to anticipate the inflation that came with the war, or if they had anticipated it, they were bound at their peril to assume that in spite of the war and taxes their net earnings over excess profit taxes would increase so as to enable them to meet the increased cost out of those earnings.

To this result the District Court's findings that the war "did not put the newspaper business in a financially precarious position or indicate any financial uncertainty for the future" (R. 54) was essential. We submit that it was arbitrary and unreasonable and without support in the record.

Said Judge Phillips in his dissenting opinion:

> "Had the World distributed as dividends in 1942, the $80,430.59, held by the Commissioner to be taxable under Sec. 102, its quick assets at the end of 1942 would have been $483,221.20, or less than the then grossly inadequate estimate of the cost of the new building and the new press and accessory equipment, leaving no liquid funds for working capital. It is obvious that the reserve set aside at the end of 1942 was not in excess of the reasonable needs of the business of the World (R. 292, 293).
>
> "* * * By May, 1945, the estimated cost of the press and accessory equipment was $636,489.38, and by August, 1945, the estimated cost of the building was $301,600. Clearly, the addition of $70,997.44 to the reserve at the end of 1943 was needed to meet justly anticipated increases in costs. In fact, it now appears that the reserves were substantially below the cost of the new press, accessory equipment, and the building, even if the Tribune Publishing Company should pay half the cost of the press and accessory equipment, which is unlikely." (R. 293)

THE DECISION CONFUTES THE TREASURY'S ASSURANCES TO INDUSTRY

The Revenue Agent and the Court in this case have gone far beyond the announced policy of the Bureau of Internal Revenue. In 1919 the Bureau announced:

> "Whether a corporation is taxable under 220* can-

*The predecessor of Section 102.

not be determined in advance, it must be determined at a later date in the light of what it has actually done with the profits retained."

1 Cumulative Bulletin 181 (1919)

And again in 1942 (CCH Par. 679.026):

"Executives are also inquiring what the Treasury will regard as 'reasonable needs of the business,' in measuring corporate surplus. Congress did not lay down in advance a definite rule applicable to all cases, and the Bureau of Internal Revenue is unable to do so. No corporation, however, will be assessed this tax until it is advised of the Bureau's intention and after a hearing of its case, at which time *the Bureau will take into consideration every fact and prospect that a prudent business man would consider in determining what surplus was reasonably needed for that enterprise.* Among other things, the Bureau will consider the hazards of that business, its normal rate of expansion, any contingencies against which reserves ought to be set up, and unemployment insurance or employee benefits that require reserves, whether the surplus is actively used in the business of the corporation or is invested in lines of business foreign to its own, together with any other facts which the particular corporation desires the Bureau to consider. With the assurance that, while the Bureau intends to apply the Acts just as they were written, it has no purpose by interpretation to extend them beyond the intent of Congress, *we believe that few executives will have difficulty in determining whether their surplus is a reasonable business surplus or whether it is withheld from stockholders for other reasons.*" (Italics ours.)

Again on December 6, 1947, CCH 1947, Par. 6285:

"George J. Schoeneman, Commissioner of Internal Revenue, in response to requests from many corpora-

tions which determine their dividend policies at this time of year, today made the following statement of administrative policy with regard to Section 102 of the Internal Revenue Code:

• • • • •

" 'Section 102, or a substantially equivalent provision, has been in the income tax law ever since the modern income tax was adopted in 1913. It never has been and is not now the policy of the Bureau of Internal Revenue to apply this provision to any corporation unless it withholds from its stockholders surplus earnings clearly in excess of the reasonable needs of the business and for the purpose of enabling stockholders to avoid personal income taxes. In determining whether surplus is retained for business purposes, it is our unvarying policy to give due consideration to the judgment of the corporation's own management as to what sums are needed for working capital, expansion of facilities, sinking funds for debt retirement, contingency funds to cover employee benefits, and similar bona fide business and legal needs. In all questionable cases, it is our policy to give the corporation's management an opportunity to explain the purpose of its surplus retention before applying Section 102. We believe the administrative record of the past 35 years provides ample assurance that Section 102 has not been, and is not being, applied so as to affect adversely the bona fide operation or conduct of any business."

When in the face of such governmental assurance, decisions like this are sought and obtained, decisions in which accumulations for the admitted needs of the business and to meet the uncertainties of war are branded as unreasonable,—in which executives are required to look into the future with all the optimism of a party chairman and the assumed infallibility of a Gallup Poll; when such vacillation exists in the interpretation and administration of the law, the importance to the country of an authoritative determination of its meaning is evident.

THE HOLDING THAT RADIO BROADCASTING IS NOT A PROPER NEWSPAPER FUNCTION IS ARBITRARY AND OF GREAT PUBLIC IMPORTANCE

> "The proposed venture into the radio broadcasting business was not a part of the needs of this business. The same finding as to remoteness would also strike down such a venture as a purpose for the accumulation by the World in 1942 and 1943." (Finding 33, R. 55)

If radio broadcasting is not a reasonable function or need of a newspaper the many newspapers now in the broadcasting business and the others applying for stations are entitled to know it. In the Tenth Circuit it is apparent that no newspaper can, with safety, accumulate earnings for such a purpose or even so utilize its existing surplus. It is the earmark in the Tenth Circuit of an improper accumulation beyond the reasonable needs of the business and one that no board of directors could in good faith authorize.

We submit that such a ruling hangs like the "Sword of Damocles" over the whole industry.

THE COURT'S DECISION CONFLICTS WITH THE DE MILLE CASE IN THE NINTH CIRCUIT

In *Cecil B. de Mille, petitioner, et al. v. Commissioner of Internal Revenue**, 31 Board of Tax Appeals, 1161, 90 Fed. (2d) 12 (C.C.A. 9) the Court found that Cecil B. de Mille Productions, Inc. had consistently over a period of years accumulated its earnings in order to build up an organization sufficiently financed for the independent production of pictures. During the years in which it was accumulating this fund it was producing pictures for other companies which financed the production of each picture. Said the Board of Tax Appeals, page 1170:

> "From the organization of Productions, throughout the time here material, de Mille and his associates, as directors of the company, continued the aim and purpose they had pursued as partners, namely, to save the company's earnings, to accumulate a fund sufficient so

*Consolidated with *Cecil B. de Mille Productions, Inc. v. Commissioner of Internal Revenue.*

that the company might be able to produce its own pictures. * * * It made no pictures except under contracts, and into the production of such pictures it put no money of its own, the funds being supplied by the other parties to the contracts. * * *"

Its surplus rose from $309,366.66 in 1924 to $1,606,515.33 in 1929. The Bureau invoked the penalty provision of the Statute for the six years, 1924 to 1929, inclusive. The dividends distributed during the six years had been insignificant. Said the Board of Tax Appeals (p. 1174):

> "And, of course, the shareholders have not paid the surtaxes for which they would have been liable had they received as dividends the amounts so withheld."

And again at 1175:

> "But the proof here goes well beyond mere denial of prohibited intent. It shows affirmatively a plan necessitating the accumulation of earnings and the end to which they might ultimately be used. The witnesses testified fully as to the purpose for which the company was formed—to create an organization for the independent production of pictures—and as to their purpose in accumulating, rather than distributing their earnings, and building a surplus—to enable that organization to finance its own production. * * *
>
> "The testimony concerning the purpose for which the corporation was formed and the purpose for which its surplus was accumulated is corroborated by the minutes of the meetings of the directors of the company—the contemporaneous record reflecting the company's activities and the reasons therefore. * * *
>
> "Nor are we ready to say that the plans for the company and the purpose for which its surplus was accumulated were too far-fetched to be within the limits of reasonable business ambition. * * *
>
> "Whether the money necessary to the realization of that determination is raised upon loans, by sale of

stock, or by conservation of earnings seems immaterial, so long as the last plan does not result in an accumulation of profits unreasonable to the needs of the business. In view of the evidence as to the costs of picture production, and as to the marketing hazards of the business which involve the risk that the talent and taste of the producer may not satisfy the public fancy, we cannot say that the surplus accumulated by this corporate petitioner was beyond that necessary to its ends. Consequently, for these reasons, we have made our finding, and hold that respondent erred in imposing upon petitioner the taxes provided by these sections of the statutes."

This decision was affirmed by the Circuit Court of Appeals of the Ninth Circuit in 90 Fed. (2d), page 12. The court says (Page 13):

"The earnings of respondent were allowed to accumulate, as the board stated 'so that the company might be able to produce its own pictures'."

The court held the finding of the board conclusive and sustained its ruling.

THE COURT'S HOLDING CONFLICTS WITH DECISIONS OF THE TAX COURT WHICH THE TREASURY FOLLOWS IN ADMINISTERING THE LAW IN SOME CIRCUITS

A fair statement of the law as pronounced in the de Mille case is found in *Rabkin and Johnson Federal Income, Gift and Estate Taxation,* at pages 635 and 636 as follows:

"The cases present such innumerable combinations of factors that generalizations are difficult. Three major factors, however, have influenced the decisions and law of the cases: (1) Are the earnings accumulated for bona fide expansion or merely for investment. (2) Are the earnings required for reasonably anticipated business contingencies. (3) Are the earnings used for loans to stockholders.

Expansion. The surtax is not designed to stifle

genuine expansion of the business, nor is it required that the expansion occur simultaneously with the accumulation of surplus. There is no unreasonable accumulation where earnings are needed for an expansion of plant and inventory, particularly for war time conditions. * * *"

In *Lion Clothing Company v. Commissioner,* 8 Tax Court 1181 (1947), over a period of many years taxpayer had followed a policy of accumulating surplus. The Tax Court said (page 1189):

> "The reason we think that earnings and profits of petitioner were not accumulated beyond the reasonable needs of its business is because petitioner has proved by evidence which seems convincing to us that in the year 1938 it adopted by appropriate corporate action a policy of accumulating a part of its net profits each year to be added to surplus 'so that the company have funds for expansion or any unseen depression that might ocur' and that this policy under all the circumstances of the case was a reasonable one and has been carried out, including the taxable years which we have before us. We do not think it can be said that a taxpayer's earnings were accumulated beyond the reasonable needs of the business where it is shown that the purpose of the accumulation is to retire mortgage indebtedness, to make improvements which will add to the convenience and efficiency of operation of the business, to expand operations by purchasing the interests of concessionaires, to accumulate some cash reserves as a bulwark against future depressions, and to meet unknown risks of the war and postwar periods * * *."

The Bureau of Internal Revenue placed its stamp of approval on this case by acquiescing in the decision. See 1947-2 Cumulative Bulletin 3.

In *Dill Manufacturing Company v. Commissioner,* 39 B.T.A. 1023, the Court pointed out that:

"However, the greater part of this surplus is the result of accumulations over many years and represents physical plant and improved manufacturing facilities by which the petitioner has been enabled to sustain and increase its income upon which it has already paid income tax." (P. 1031)

And again on the same page:

"The question of what are reasonable or unreasonable needs of business is always one of fact. The answer is rarely easy to find. However, the law does not require that 'a business should remain static; it must be assumed that any business shall have the right to grow.' William C. de Mille Productions, Inc., supra. A *fortiori,* a corporation certainly must have the untrammeled right, within reasonable limits, to financially protect itself and its shareholders.

"Justice Holmes once said, 'A page of history is worth a volume of logic,' New York Trust Co. v. Eisner, 256 U.S. 345. Thus, the economic history of the country and this company is both pertinent and illuminating. So, particularly where, as here, the petitioner is not a holding company but is engaged in a manufacturing business, which is so obviously hazardous from a business viewpoint, we will hesitate before substituting our judgment upon the reasonableness of the corporate accumulations, for that of the directors. See Klug v. Smith Co., 18 B.T.A. 966."

In *Kennedy Name Plate Company, a corporation, v. Commissioner,* Tax Court Dec. 15841M, Docket No. 6695 (1947) Vol. 6 Tax Court Memo. Decisions page 622, the Commissioner assessed the penalty tax against the defendant manufacturer of name plates for the years 1941 and 1942. It was testified that the earnings were being accumulated for the purpose of putting up a building, installing a new press and other machinery. The estimated minimum

cost of these improvements was $279,000. At the time of the trial in 1947 petitioner had still been unable to erect the building or purchase the press and other machinery. Said the Tax Court, p. 632:

> "We are convinced from the evidence that the above business needs as testified to by Hayek and Kennedy are all reasonable requirements for the continued successful operation of petitioner's business. As was said in William C. de Mille Productions, Inc., 30 B.T.A. 826, 'it must be assumed that any business shall have the right to grow.' * * *
>
> "We do not understand that Section 102 of the Internal Revenue Code and the regulations promulgated thereunder prevent a taxpayer corporation from making a reasonable accumulation of its earnings to finance expansion and modernization programs out of its own funds rather than to resort to borrowing it for that purpose" (p. 633).

CONCLUSION

The court in this case substitutes itself for the Board of Directors and concludes in the light of subsequent events that it would have acted differently than did the Board. From that fact, it finds the action of the Board unreasonable and imputes improper motive under section 102. The dissent of the Senior Circuit Judge however declares the directors merely exercised "ordinary business prudence." That he would have voted as a director as did those on the World's Board, is clear from his whole opinion. To declare that such action indicates "improper motive" under the statute is clearly a misconception of the law.

The lower court has decided important questions of Federal law which have not been but should be decided by this court. The decision of the Circuit Court of Appeals in this case is contrary to the general interpretation of the law in other circuits, is contrary to the position taken by the Treasury Department itself in most circuits and will lead

to unending discrimination and confusion. It is hard to escape the conclusion reached by Judge Phillips in his dissent when he said:

> "Aside from the fact that had dividends been declared in 1942 and 1943 the income tax liability of Mr. Lorton would have been greatly increased, it seems to me there is nothing in this record to justify the conclusion of the trial court."

It needs no argument to demonstrate that the amount of Mr. Lorton's tax has nothing whatever to do with the reasonable needs of the newspaper for building, plant, and war emergencies.

We respectfully urge that the petition for *certiorari* be granted.

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APPENDIX

Statute, Sec. 102, Internal Revenue Code:

(a) "Imposition of Tax.—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

38½ per centum of the undistributed section 102 net income in excess of $100,000.

(b) "Prima Facie Evidence.—The fact that any corporation is a mere holding or investment company shall be *prima facie* evidence of a purpose to avoid surtax upon shareholders.

(c) "Evidence Determinative of Purpose.—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary."

NOTE: Sections (d), (e) and (f) are not in controversy in this case.

Regulations 111 provide in part as follows:

Sec. 29.102-2:

* * * * *

"If the Commissioner determines that the corporation was formed or availed of for the purpose of avoiding the individual surtax through the medium of permitting earnings or profits to accumulate, and the taxpayer contests such determination of fact by litigation, the burden of proving the determination wrong by a preponderance of evidence, together with the corresponding burden of first going forward with evidence, is on the taxpayer under principles applicable to income tax cases generally, and this is so even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits. However, if the corporation is a mere holding or investment company, then the Internal Revenue Code gives further weight to the presumption of correctness already arising from the Commissioner's determination by expressly providing an additional presumption of the existence of a purpose to avoid surtax upon shareholders, while if earnings or profits are permitted to accumulate beyond the reasonable needs of the business, then the Code adds still more weight to the Commissioner's determination by providing that irrespective of whether or not the corporation is a mere holding or investment company, the existence of such an accumulation is *determinative* of the purpose to avoid surtax upon shareholders unless the taxpayer proves the contrary by such a clear preponderence of all the evidence that the absence of such a purpose is unmistakable."

"Sec. 29.102-3. Unreasonable accumulation of profits.—An accumulation of earnings or profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent accumulations of surplus for the reasonable needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt is here made to enumerate all the ways in which earnings or profits of a corpora-

tion may be accumulated for the reasonable needs of the business. *Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of earnings or profiits is immaterial if they are not in fact needed in the business.** Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed earnings or profits will be considered in determining the reasonableness of the accumulations.

"The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax. * * *"

*Italics ours.